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IN THE

Supreme Court of the United States

OCTOBER TERM, 1950

No. 644.

GEORGE T. GOGGIN, as Receiver of the Estate of Salsbury Motors, Inc., Debtor,

Petitioner,

vs.

BANK OF AMERICA NATIONAL TRUST & SAVINGS ASSOCIATION,

Respondent.

Reply Brief of Petitioner in Support of Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

Your petitioner herein is seeking a review by this Court of a judgment of the United States Court of Appeals for the Ninth Circuit which affirmed an order of the bankruptcy court denying a petition of the receiver to subordinate the claim of the Bank of America under a confirmed plan of arrangement. There was no hearing on the merits because the referee and the district judge were of the opinion that the bankruptcy court was without jurisdiction to entertain the petition. The receiver sought in his peti-

tion to defer any payment of dividends to the Bank on its claim against the debtor until all the other creditors of the debtor had been paid, upon the ground that the Bank was guilty of such misconduct in dealing with all the other creditors of the debtor as to require the bankruptcy court, under the doctrine of *Pepper v. Litton* (1939), 308 U. S. 295, 84 L. Ed. 281, 60 S. Ct. 238, 41 A. B. R. (N. S.) 279, to subordinate the payment of dividends on the Bank's claim in order to prevent injustice and unfairness in the administration of the estate. The drastic judgment of the court below would operate to deny the receiver the opportunity to prove the conduct of the Bank, which was described in the receiver's original petition and supplement thereto [Tr. 58-65], and the amended petition [Tr. 92-107], so that the truth and significance of the facts alleged by the receiver can be ascertained.

The reasons underlying a judgment or order which denies a party his day in court should be compelling. It is upon this ground that the courts have universally applied the rule that in cases sought to be determined upon their pleadings, every inference must be drawn in favor of the pleader, and that, in ruling upon the sufficiency of the pleadings, the allegations thereof are deemed admitted. The position of the Bank, as set forth in its brief in opposition to the writ, is grounded upon a rejection of these fundamental and elementary principles.

The sole contention of the Bank is that in bankruptcy proceedings the allowance of a claim over objections necessarily adjudicates any and all issues pertaining to the

order of payment of dividends on that claim.[1] Stated otherwise, the Bank takes the position that once a claim has been allowed by the bankruptcy court, that court is forever precluded, not only from reconsidering that allowed claim, but also from considering whether or not dividends shall be paid on that claim at the same time dividends are paid to other creditors who have been preju-

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[1]This is a rejection of the rule of *Pepper v. Litton* in which this Court stated:

> "Though disallowance of such claims will be ordered where they are fictitious or a sham, these cases do not turn on the existence or non-existence of the debt. Rather, they involve simply the question of order of payment." 308 U. S. 295, at 310, 84 L. Ed. 281, 60 S. Ct. 238, 41 Am. B. R. (N. S.) 279.

In the first footnote to its brief herein on page 7 thereof, the Bank questions whether or not the original petition and the amended petition to subordinate the Bank's claim herein state valid grounds for subordination. The Bank refers to *Comstock v. Institutional Investors,* 335 U. S. 211, 92 L. Ed. 1911, and *Manufacturers Trust Co. v. Becker,* 338 U. S. 304, 94 L. Ed. 107, 70 S. Ct. 127. Each of these cases involved a full hearing upon a petition to subordinate upon the basis of which this Court concluded that subordination should not be granted. In neither case was there any question as to the right of the bankruptcy court to order subordination upon appropriate findings and there was implicit in both rulings a reaffirmation of the basic principle that the bankruptcy court has jurisdiction to hear and determine such petitions to subordinate.

After citing the two Supreme Court cases, the Bank refers to several United States Court of Appeals cases, the most recent of which was decided in 1935 and all of which preceded *Pepper v. Litton.* Among the numerous cases recognizing the power of the bankruptcy court to subordinate the payment of dividends on allowed claims are the following:

In re Headley (1899, D. C., Mo.), 97 Fed. 765, 3 A. B. R. 272;

In re Royce Dry Goods (1904, D. C., Mo.), 133 Fed. 100, 13 A. B. R. 257;

Carter v. Bogden (1926, 8th Cir.), 13 F. 2d 90, 8 A. B. R. (N. S.) 247;

(Footnote continued on following page.)

diced by the misconduct of the claimant. Upon this premise the Bank argues that the question presented by the instant case is of no importance and should, therefore, not be considered by this Court.

That such propositions are being urged demonstrates the compelling need for this Court to grant the petition herein.

Bird & Sons v. Tobin (1935, 8th Cir.), 78 F. 2d 371, 100 A. L. R. 654, 29 A. B. R. (N. S.) 171;

Pepper v. Litton (1939), 308 U. S. 295, 84 L. Ed. 281, 60 S. Ct. 238, 41 A. B. R. (N. S.) 279;

Bank of America v. Erickson (1941, 9th Cir.), 117 F. 2d 796, 45 A. B. R. (N. S.) 503;

Goldie v. Cox (1942, 8th Cir.), 130 F. 2d 695, 50 A. B. R. (N. S.) 560;

Prudence Realization Corp. v. Geist (1942), 316 U. S. 89, 86 L. Ed. 1293, 62 S. Ct. 978;

Columbia Gas & Electric Corp. v. U. S. (1945, 6th Cir.), 151 F. 2d 461, rehear. den. 153 F. 2d 101, *cert den.* 329 U. S. 737;

In re Loewer's Gambrinus Brewery Co. (1948, 2nd Cir.), 167 F. 2d 318;

In re Inland Gas Corp. (decided March 19, 1951, 6th Cir.), reported at paragraph 56,956 of Commerce Clearing House Bankruptcy Service in the issue of April 18, 1951.

In the light of these authorities there can be no reasonable difference of opinion over the proposition that the Bankruptcy Court has complete jurisdiction to order subordination of a claim to other claims of the same class whenever the facts require such an order to further the ends of equity and justice in the distribution of the assets of a bankruptcy estate. These authorities also establish that a trustee in bankruptcy, or a receiver, has not only the power but the duty to bring appropriate proceedings toward this end. The pleadings in the instant case (both the original and amended petitions) fall within the rules of these cases and if, after a trial, the receiver proves those allegations, the bankruptcy court would be required to order that payment of dividends on the Bank's claim be subordinated to the claims of all other creditors.

See also in this connection:

3 Collier on Bankruptcy (14th Ed.) 185, 1809-1810;

6 Remington on Bankrupcty 477;

6 Remington on Bankruptcy (1947 Supp.), 138.

ARGUMENT.

I.

The Banker's Lien Proceeding Did Not Involve Any Issue or the Consideration of Any Evidence as to the Subordination of the Bank's Claim and, Therefore, Could Not Have Determined Any Such Issue; Ergo, There Could Be No Basis for Res Judicata.

In attempting to establish that there was no real distinction between the banker's lien proceedings and the subordination proceedings the Bank makes the following bald assertion to page 9 of its brief herein:

> "The ultimate issue in both phases of the case was whether the Bank's claim on file in the proceedings should be allowed for the purpose of permitting it to participate in dividends."[2]

An examination of the record in the banker's lien proceeding unequivocally demonstrates that there was never an issue as to the Bank's ultimate right to participate in dividends. As a matter of fact, there was never any question but that the debtor was indebted to the Bank. The pleadings [B. L., Tr. 48, 37] and the evidence [B. L., Tr. 68] in the banker's lien proceedings show that the only issue was the amount of the Bank's claim, the receiver contending that the Bank's claim should have been in a greater amount than that claimed by the Bank because the Bank had wrongfully asserted a lien on certain

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[2]Even if this were true (which it is not) the bankruptcy court would have the authority to reconsider the allowance of a claim at any time while the bankruptcy proceedings are pending. See Sections 57(k) and 57(l) of the Bankruptcy Act and the discussion contained at pages 25 to 29 of the petition for certiorari herein.

moneys and properties belonging to the debtor. At no time did the receiver attempt to defeat the claim of the Bank. In the banker's lien proceedings the receiver sought to defer a determination of the amount of the Bank's claim until the value of the security asserted by the Bank had been determined.

The second and basic aspect of the banker's lien proceeding was a counterclaim in which the receiver sought to have the Bank turn over to the estate the commercial paper, or the proceeds therefrom, upon which the Bank had asserted a banker's lien. It is thus clear that the receiver never contended that the Bank did not have a valid claim against the debtor.

The Bank concedes on page 11 of its brief herein that in determining the scope and effect of any judgment or order the Court must resort to the pleadings and evidence presented in the earlier proceedings to determine whether or not the issues raised by the more recent litigation were determined in the previous litigation.[3] Never-

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[3]See *Vicksburg v. Henson* (1913), 231 U. S. 259; *Radford v. Myers* (1914), 231 U. S. 725, and *Reynolds v. Stockton* (1891), 140 U. S. 254.

In *Vicksburg v. Henson,* this Court stated, at 231 U. S. 268:

> "Coming to the question whether the former decree disposed of the rights of the parties, as was held in the court below, which judgment was affirmed by the Circuit Court of Appeals, it is undoubtedly true that a right, question or fact put in issue and decided by a court of competent jurisdiction must be taken as settling the rights of the parties in respect to such controversy and while it remains undisturbed is conclusive between them. The enforcement of this rule has been repeatedly said to be essential to secure the peace and repose of society and in order that an end may be made of controversies between parties who have once invoked and have had the determination by a competent judicial tribunal of the matters in dispute between them. It is no less true that to hold

(Footnote continued on following page.)

theless, it is unable to demonstrate from the record in the banker's lien proceedings, either in the pleadings or the evidence, where there was an issue as to the Bank's right to participate in dividends. The only thing in the entire record in the banker's lien proceedings in any way remotely pertaining to the participation in dividends is the last paragraph of the order of the referee. This contained the only language relied upon by the Court of Appeals and the Bank. That language, read in context, was merely a direction to the receiver that no dividends were to be paid to the Bank until its security had been liquidated. Obviously, until that time, the exact amount of the Bank's claim would be unknown. A recent decision of the Court of Appeals for the Second Circuit makes it

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upon any unsubstantial ground that a controversy has been thus concluded is to do an injustice to litigants. We must therefore be careful to see, when the contention of former adjudication is made, that the matter was actually presented and decided and the rights of the contending parties thereby concluded. We think that an examination of the record in the former case, put in evidence in this case, does not support the contention that the matter here in issue was then adjudicated and determined."

There this Court reversed a judgment of the Court of Appeals for the Fifth Circuit which had, as did the Court of Appeals in the instant case, upheld a plea of *res judicata* by reason of a strained literal construction of the judgment in an earlier case.

The same principle was applied by this Court in *Pepper v. Litton.* Although a claim asserted in a bankruptcy was based upon a final binding judgment of a state court, this Court, nevertheless, held that the judgment was not *res judicata* in a bankruptcy proceeding when the trustee attempted to subordinate the payment of dividends on the claim based upon the judgment because the record of the state court proceeding showed that the issues as to subordination had never been raised. The only distinction between that case and our case is that the *Litton* judgment was issued by a state court whereas in our case the order in the banker's lien proceedings was issued by the bankruptcy court. The position of the Bank would give the judgment of the bankruptcy court a greater finality than that of a state court, even though the evidence and pleadings raised no issue concerning subordination.

clear that under the Bankruptcy Act there may never be a final allowance of a secured claim until the security has been liquidated or appraised. In *New York, N. H. and H. R. Co. v. Reconstruction Finance Corporation* (2nd Cir., 1950), 180 F. 2d 241, the question presented was whether the bankruptcy court had jurisdiction to entertain a petition requesting the same relief that had been previously denied by the bankruptcy court. In that case the denial was affirmed by the Court of Appeals on an appeal from the original order which had long since become final prior to the filing of the new petition. As already pointed out, the second petition was for the same relief that had already been denied. However, there was a different legal ground urged to support the second petition. Judge Learned Hand, speaking for the Court, stated that the bankruptcy court had jurisdiction to entertain the new petition and that if the bankruptcy court had any discretion whether to entertain the petition or not, it would have been an abuse of discretion not to do so[4] (180 F. 2d at 243).

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[4]Judge Hand made the following pertinent observation as to the finality in bankruptcy proceedings of any order allowing a secured claims:

> "On the other hand, §57, sub. e, provides that secured claims shall be only 'temporarily' allowed; and then only for purposes of voting, and at amounts which 'seem' to the court to represent the deficiency of the security to pay them in full. Section 57, sub. h, provides for the liquidation of the security, which is to be, either in accordance with the terms of the agreement between the bankrupt and the creditor, or by compromise, or litigation, 'as the court may direct.' The important thing is that there is to be no 'allowance'—except the 'temporary' one—until the value of the security has been ascertained, and that, when it has been ascertained, is to be 'credited' upon the claim and dividends are to be paid only upon the balance. Thus there could be no final 'allowance' of the claim in suit until the amount of the security had been appraised, which involved as one factor the interest in dispute." (180 F. 2d 246.)

The case of *New York, N. H. and H. R. Co. v. Reconstruction Finance Corporation, supra,* is in direct conflict with the ruling of the Court of Appeals for the Ninth Circuit in the instant case.

II.

The Allowance of a Claim in Bankruptcy May Be Reconsidered at Any Time While the Bankruptcy Proceedings Are Open.

For the reasons stated in the petition herein and in the foregoing portions of this reply brief, the banker's lien order was not *res judicata* as to any issue presented by the petition for subordination. However, if it be assumed for the purposes of this argument, as held by the Court of Appeals, that ". . . the last paragraph of said [banker's lien] order decided the question of priority of the bank's claim . . ." [Tr. 201], the ruling that it necessarily follows that the bankruptcy court was without jurisdiction to reconsider that order is in direct conflict with the Bankruptcy Act and the governing authorities thereunder. No purpose would be served by repeating the discussion of the authorities contained in the petition for certiorari; we only mention them herein to point out that nowhere in the Bank's brief has any answer been made to them. Just as the Court of Appeals and the Bank have taken out of context language from the banker's lien order the Bank has, on page 14 of its brief herein, quoted out of context a statement of counsel before the referee in a strained effort to support a conclusion that the receiver waived the right to ask the bankruptcy court to reconsider the allowance of the Bank's claim. The record before this Court does not

contain the complete transcript of the hearing in which the statement of counsel quoted by the Bank on page 14 of its brief appeared. However, even the portion included in the record shows that the quoted language does not have the meaning given it by the Bank when considered in its context. The statement of counsel appears in this record at page 157 thereof and reads as follows:

> "At this time we are not objecting to the allowance of any claims of the Bank of America. If that is not clear from our pleadings, it is only because they have not read those pleadings. What we are seeking to do by our subordination proceedings is to obtain from this Court an order subordinating any claims of the Bank of America as ultimately allowed. It is true the Bankruptcy Act under its express provision gives the Court the right to reinquire into any orders made on allowance of claims or objections thereto. We could proceed under that authority, but we are not. We are proceeding on the basis that whether the claims of the Bank of America amount to $198,818.44, as it will amount to in the gross if the banker's lien litigation is affirmed, or if reversed it will be in some greater amount, but whatever amount is allowed ultimately that the payment of dividends on that allowed claim are subordinated."

It clearly appears from the foregoing that all counsel was stating was that until the banker's lien litigation became final the Bank's claim could not be liquidated, but that in any event, whether the receiver was successful or not, the Bank would have an allowed claim; further, that the receiver was attempting, upon the basis of his petition to subordinate, to present evidence to the Court

that the Bank's claim, in whatever amount it was ultimately found to be, be deferred until the claims of other creditors, misled by the conduct of the Bank, were paid in full. Clearly there was no waiver of any rights under Section 57(k) of the Bankruptcy Act. The receiver's counsel was merely contending that the subordination proceedings were separate and distinct from the banker's lien proceedings and, therefore, a motion to reconsider the banker's lien order was inappropriate at that time. If the ruling of the Court below, however, is correct, counsel for the receiver made the statement under an apparently erroneous legal theory. But this does not prevent reconsideration; in fact, a refusal to reconsider an order in these circumstances would be an abuse of discretion according to the Court of Appeals for the Second Circuit in *New York, N. H. and H. R. Co. v. Reconstruction Finance Corporation* (1950), 180 F. 2d 241, where the Court stated:

> "Rule 60(b)(1), Federal Rules of Civil Procedure, 28 U. S. C. A., would have given him discretion to relieve the trustees from their 'excusable neglect' in failing to adduce all the appropriate legal grounds to support their claim; and it is obvious that he would have exercised his discretion in their favor; indeed, it would have been an abuse of it not to do so."

Since the filing of the petition herein another circuit has come down with a ruling in conflict with the Court of Appeals for the Ninth Circuit in the instant case. In the case of *In re Inland Gas Corp.*, decided March 19,

1951, the United States Court of Appeals for the Sixth Circuit squarely held that the bankruptcy court was not to be precluded from reconsidering the same questions as were presented on a former appeal in which the mandate had long since become final. The Court stated:

> ". . . Here the securities of Columbia were tainted with inequity from the very beginning, and no reasonable expectation may be indulged that in the present status of the debtors there may come a time when Columbia may assert any right in such securities as against creditors who have not been injured by its illegal and inequitable conduct. This is not to say that subordination is not a more appropriate remedy than rejection, in view of the principle applied in the *Hartford-Empire* case, if by it a just result may be reached. Nor are we precluded by our previous mandate, even if susceptible to the interpretation put upon it by the district court, from considering whether the plan of reorganization, now for the first time presented, is, in the light of all circumstances brought forth, fair and equitable, since the allowance of claims in bankruptcy remains interlocutory until the estate has been closed, *New York, N. H. & H. R. Co. v. Reconstruction Finance Corp.,* 180 Fed. (2d) 241, 243 (C. A. 2), and no application of the principle of 'the law of the case' need deter us from so doing, in an exceptional case, which this is, *Reynolds Spring Co. v. L. A. Young Industries,* 101 Fed. (2d) 257 (C. A. 6), however such principle may circumscribe the action of a district court."[5]

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[5]The official citation for this case is not yet available but it may be found at paragraph 56,956 of the C. C. H. Bankruptcy Service in the issue of that service dated April 18, 1951.

Conclusion.

The Bank apparently asserts that the scope of the decision of the Court of Appeals in the instant case is so narrow as to make it unworthy of consideration by this Court. The holding of the Court below seems to have been predicated upon an extremely narrow issue but it is one that, if allowed to stand, will mean that a bankruptcy court may never entertain a petition to subordinate the payment of dividends upon a claim if that claim has been previously allowed. This is in direct conflict with decisions of this Court, with decisions in the First, Second and Sixth Circuits, with the express provisions of Section 57 of the Bankruptcy Act, and is of vital importance to the uniform administration of the Bankruptcy Act throughout the United States.

We cannot resist the temptation to point out that, by refusing to grant the Petition for Certiorari in the Bankers lien litigation, this Court, in effect, permitted the Bank to prefer itself over other creditors to the extent of approximately $180,000, in addition to the fact that the Bank exercised its right of setoff and seized over $160,000 in cash then on deposit when the Chapter XI proceedings commenced. If the within Petition for Writ of Certiorari is denied, the net result will be that the reprehensible conduct of the Bank, complained of in the subordination pleadings before the Referee (and admitted here) seeking relief by way of subordination of payment of dividends on the claim of the Bank, will never receive the consideration of a court of equity. While we would be reluctant to urge that the position of the Bank is frivolous, we cannot believe that it is completely serious in arguing that an objection to a claim on the basis that the claimant has wrongfully converted moneys belonging

to the estate is the same as a petition seeking to subordinate the payment of dividends on an allowed claim because of the inequitable conduct of the claimant, prior to bankruptcy, in dealing with all of the creditors.

After carefully combing the record, pleadings and briefs submitted to the Court of Appeals, we are still unable to ascertain what motivated the Court below to recognize what appears to be such an untenable argument, particularly in view of the fact that even if the Court of Appeals erroneously thought the Referee below intended to pass on the question of dividends in the Bankers' lien litigation, nevertheless it completely failed to consider the decisions of this Court, at least two other circuits (now enlarged by the Sixth Circuit ruling in the case of *In re Inland Gas Corp.,* decided March 19, 1951), and the express provisions of the Bankruptcy Act providing for reconsideration of claims and the payments of dividends thereon at any time prior to the closing of a bankruptcy administration. Certainly, if the Bankrupty Act spells out the right of a Receiver or Trustee to seek the return of a dividend which was subsequently determined to hav been erroneously paid (Section 57(1)), how could the Court of Appeals justify its conclusion that the Court below had no jurisdiction to either reconsider its ruling or to consider new matters seeking different relief?

As pointed out by the Bank in the conclusion of its brief herein, the receiver has been engaged in extensive litigation with the Bank arising out of the within Chapter XI proceedings. The receiver has been before the Circuit Court and this Court previously in order to question the propriety of the Bank's exercise of a banker's lien by reason of which it obtained in excess of $180,000 before any other creditors of the debtor received anything. The

receiver is now before this Court a second time after being unsuccessful before the Referee, the District Court, and the Court of Appeals, only because he feels so strongly that established principles of bankruptcy law, as well as equity and justice, require the granting of an opportunity to prove that the conduct of the Bank prevents it from participating in the distribution of the assets of the estate until the creditors who were misled by the Bank's wrongful conduct have been paid.

Wherefore, it is respectfully urged that the petition for writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit be granted, that the judgment of that Court be reversed, that the entire matter be remanded to the bankruptcy court with directions to proceed upon the allegations of the receiver's amended petition to subordinate the claim of the Bank of America.

Dated: This 9th day of May, 1951.

Respectfully submitted,

MARTIN GENDEL,
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H. MILES RASKOFF,
Of Counsel.